

# Products of Insular Possessions Pre-Assessment Survey

## Internal Control Technical Guide

### Objective

Provide guidance in performing a Pre-Assessment Survey (PAS) of the company's internal control for merchandise entered as products of insular possessions (IP) and evaluating the results.

### Background

Generally Accepted Government Auditing Standards require the PAS team to obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed.

The guidelines and terms in this technical guide are based on *Assessing Internal Controls in Performance Audits*, GAO/OP-4.1.4, published by the United States General Accounting Office, Office of Policy, September 1990; and the American Institute of Certified Public Accountant's *Statement on Auditing Standards No. 78*.

Regulations governing IPs are in 19 CFR Part 7. In addition, General Note 3(a)(iv) of the Harmonized Tariff Schedule of the United States (HTSUS), provides the criteria for preferential treatment of products produced in IPs. For purposes of this technical guide, only sections 7.2, 7.3 and 7.4 of 19 CFR will apply. Additionally there is a Customs Informed Compliance document on IP dated June, 1999.

Additional guidance may be found in:

- C.S.D. 85-25 (double substantial transformation);
- Ruling 556193, dated 12/23/91 (dual-sourcing);
- Ruling 557087, dated 7/22/93, T.D. 81-282, T.D. 78-399, and C.S.D. 80-208 (unallowable general and administrative costs); and
- Ruling 559010, dated 3/14/96 and T.D. 91-7 (treatment of components in sets).

Insular possessions of the U.S. include; the U.S. Virgin Islands, Guam, American Samoa, Wake Island, Midway Islands, Johnston Atoll, and the Commonwealth of the Northern Mariana Islands which are to be treated just as articles from Guam. See section 7.2(a) of 19 CFR.

Importations to Insular Possessions are not governed by the Tariff Act of 1930, as amended (19 CFR 7.2(b)).

To qualify for duty free treatment, products of insular possessions must:

- Be wholly the growth or product of the insular possession; or the good must become a new and different article as a result of manufacture or production in the insular possession, (See section 7.3(b) of 19 CFR)
- Not contain foreign materials that represent more than 70 percent of the goods total value; or in the case of IP goods described in section 213(b) of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2703(b)), more than 50 percent\*\* of the goods total value. (See section 7.3(a)(1)(i) of 19 CFR).

- Come directly to the U.S. from the insular possession; (See sections 7.3(a)(1)(ii) and 7.3(e) of 19 CFR)

\*\*The 50 percent value content requirement for products of IPs applies to the goods listed in section 10.233(a) of 19 CFR.

A producer of an IP product is required to incorporate any foreign material into the good no later than 18 months after importation from the foreign supplier (See section 7.3(c)(3)(ii) of 19 CFR). The following HTSUS provisions provide additional guidance for specific commodities when these commodities are the products of an IP:

- Additional U.S. Note 5 of chapter 91;
- Additional U.S. Note 2 of chapter 96, and except as provided in section 423 of the Tax Reform Act of 1986, as amended (19 U.S.C. 2703 note); and
- Additional U.S. Note 3(e) of chapter 71.

## Examples of Red Flags

The following examples are conditions that may indicate a potential problem with the merchandise entered as products of IPs.

- Company has insufficiently documented, poorly defined, or no internal control for accurately declaring merchandise entered as products of an IPs for Customs purposes.  
Examples:
  - ✓ Company does not monitor or interact with the broker on IP eligibility issues.
  - ✓ Company relies on one employee to handle IP merchandise, and there are poor or no management checks or balances over this employee.
- Company staff lacks knowledge of IP eligibility issues.
- The company's import manager lacks cost accounting knowledge
- Company offers unreasonable explanations to Customs.
- Company fails to cooperate or respond to Customs.
- Company has high turnover of people in key positions.
- Significant variance exists between the importer's data and Customs' data.
- Customs (import specialist, account manager, compliance measurement, prior audit, profile) shows history of problems with IP merchandise.
- Company has either, never previously imported IP merchandise, or there was a large increase of imports of IP merchandise from a prior period.
- The importing company obtains identical articles from two different countries, where one of the countries is an insular possession and the other is not.
- The IP producer sources materials to produce the IP article from two different countries, where one of the countries is an insular possession the other is not.
- The importer does not request, maintain, or review documents supporting the qualification of IP merchandise (e.g., value content qualification).
- The importer and the IP producer are related.
- There is no prior audit or Customs review of the company's IP imports.
- Company does not monitor the IP classification or records process.
- The goods do not have markings to determine the country of origin.

- The company cannot provide a list of foreign suppliers and the types of goods the supplier provides.
- Amounts on cost sheets for unallowable general expenses and profit appear unusually low, indicating that allowable costs may be overstated.

### **Examples of Best Practices**

- Internal controls over merchandise entered as products of IPs:
  - ✓ Are in writing,
  - ✓ Include procedures for monitoring and feedback, and
  - ✓ Are monitored by management.
- One manager is responsible for control of the import department, including merchandise entered as products of IPs. That manager has knowledge of customs matters and the authority to ensure that internal control procedures for imports are established and followed by all company departments.
- Written internal control procedures assign duties and tasks to a position rather than a person.
- The company conducts and documents periodic reviews of merchandise entered as products of an IP, and uses the results to make corrections to entries and changes to their import operations as appropriate.
- The company has good interdepartmental communication about Customs matters.
- Importer has procedures to obtain any required or necessary documentation from its suppliers to support IP eligibility. (e.g., penalty provisions on the supplier in the purchase order if IP content information is not provided to Customs on demand).
- Importer maintains a database or listing of imported merchandise that would readily identify IP transactions.
- The company has a program in place to prevent transshipment.
- The company can itemize the value of the materials used.
- The company can readily provide listing of goods that are products of IPs.
- The company can provide the origin of the materials used in the production of the goods from the IP.
- The company visits the plant in the IP country where the products are produced.

### **Examples of IP Documents and Information to Review**

- Internal control policies and procedures.
- The company's response to the questionnaire.
- Interviews with company staff concerning actual procedures and controls specific to merchandise entered as products of IPs.
- Country of origin markings on products and components.
- Company's documentation that supports monitoring and verification of established and/or written internal control for merchandise entered as products of IPs including:
  - ✓ A declaration by the shipper in the IP.
  - ✓ Certificate of Origin (Customs Form 3229).
  - ✓ Listing of goods that are products of IPs.
  - ✓ Invoices providing a description and origin of the IP products.
  - ✓ Specification sheets, drawings, or bills of material depicting the products of the insular possession that are included in the produced goods.

- ✓ Bills of Lading that show direct transport from the U.S. to the IP and/or direct transport from the insular possession to the U.S.
- ✓ Proof that the goods of the IPs have not been claimed for drawback.
- ✓ Listing of origin of the products used in production.
- ✓ Travel documents that show the company visited the manufacturers or factories to verify that the products were manufactured produced in the IP.
- ✓ Customs Form ITA-361, Request for Refund of Duties on Watches and Watch Movements.
- ✓ Manufacturer's affidavits as to country of origin of components.
- ✓ Bills of material listing country of origin for components, whether foreign vendors are related or unrelated.
- ✓ "Where used" reports ("exploded " bills of material) showing that components underwent "double substantial transformation".
- ✓ Accounting records supporting product cost sheets, including financial statements, post-closing trial balance, detailed chart of accounts, and general ledger detail.

### Suggested Testing

PAS team judgement should be used to determine the type and amount of testing needed to evaluate how effective internal control is and whether there is sufficient risk to warrant proceeding to the Assessment Compliance Testing (ACT) phase.

Using the chart and the guidelines below, determine through judgmental testing whether the company's internal control in place is effective.

To determine the extensiveness of internal control testing, it is necessary to evaluate:

1. The **risk exposure**, and
2. The **internal control** system by determining whether the controls are in operation, how the controls were applied, how consistently they are applied, and who applied them.

### Risk Exposure

Risk exposure is the probability of significant Customs noncompliance. In each step of determining risk exposure, consideration should be given to:

1. Significance (to Customs) and sensitivity (e.g., issues of interest to Congress or the media, or impacting admissibility).
2. Susceptibility (of making incorrect declarations).
3. The existence of any "red flags."
4. Management support (of strong internal control).
5. Competent personnel (to adequately administer the controls).

*Steps to Determine Risk Exposure:*

1. Evaluate problems identified in the profile, compliance measurement rates, questionnaire, and concerns raised by the import specialist and account manager.
2. Perform the macro risk analysis tests.
3. Analyze all results to determine the risk exposure level.
4. Evaluation of risk exposure is not simply a one-time process that occurs at the start of the PAS process. Continually reassess risk exposure as more information is gathered from evaluating internal control and performing other work in the PAS.

**Macro Risk Analysis Examples***Example A: Low Risk Exposure*

The import specialist, account manager, and the profile did not identify specific concerns with this importer's IP program. There were no inconsistencies in the importer's responses to the questionnaire. The PAS team compared the total IP merchandise value from the company's data to the value reported in ACS and determined there was an insignificant variance. The goods, claimed as duty-free under the IP provisions, are grown or produced in the IP. Because there were no PAS team concerns and there was little variance between the importer's IP data and Customs' ACS data, the risk exposure level was considered low.

*Example B: High Risk Exposure*

The import specialist, account manager, and the profile identified specific concerns with this importer's IP program. In addition, there were inconsistencies in the company's responses to the General Questionnaire. The PAS team compared the total value of IPs from the importer's data to the value reported in ACS and determined a significant variance. The PAS also determined that the goods, claimed as duty-free under the IP, were not grown or produced in the IP. Because of PAS team concerns and the IP value discrepancy between Customs and the importer, the risk exposure level was considered high.

**System of Internal Control**

To evaluate the internal control system:

1. Consider the five components of internal control:
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communication
  - Monitoring

2. Review relevant Customs and company documents to identify and understand relevant internal control over merchandise entered as products of an IP (Examples of documents and information to review are listed on the prior page).
3. Determine whether the company established and follows procedures. Review:
  - Documentary evidence of the results of periodic internal control reviews/testing and corrective action implemented.
  - Documentary evidence of communication between the broker and company on merchandise entered as products of IP issues, company testing of broker operations and verification that the broker followed company instructions.
  - Company-specific IP rulings and evidence that they are followed.
  - Documentary evidence of intra-company communications to ensure correct information is provided to Customs.
  - Training records and materials relating to IP used to educate staff on Customs matters.
4. Review written policies and procedures and interview applicable company personnel to complete appropriate sections of the "Worksheet for Evaluating Internal Control for Products of Insular Possessions."

Note: The internal control assessment should include steps to:

- Identify and understand internal control
- Determine what is already known about control effectiveness
- Assess the adequacy of internal control design
- Determine whether controls are implemented and effective
- Determine whether transaction processes are documented

### Extensiveness of Audit Tests (Testing Limit)

The purpose of limited PAS testing is to take a survey in order to determine the necessity for and extent of substantive tests. In some circumstances, the PAS team may decide that it probably will not be able to form an opinion based on limited PAS testing. In such cases, it may be necessary to proceed immediately to the ACT process. If the PAS team believes it can form an opinion based on limited PAS testing, test the appropriate number of controls and associated transactions using the table below. Tests may be appropriate for various areas below the total IP level on which compliance will be reported. For example, the company imports from several foreign companies, but testing may be necessary only for certain companies or only certain products that have been identified as primary risks.

#### Determine Extensiveness of Audit Tests

Risk Exposure	+	Preliminary Review Internal Control	=	Extensiveness of Audit Test	Testing Limit
High		Weak Adequate Strong		High Moderate to High Low to Moderate	10-20

<b>Risk Exposure</b>	<b>+</b>	<b>Preliminary Review Internal Control</b>	<b>=</b>	<b>Extensiveness of Audit Test</b>	<b>Testing Limit</b>
<b>Moderate</b>		Weak Adequate Strong		Moderate to High Moderate Low	5-15
<b>Low</b>		Weak Adequate Strong		Low to Moderate Low Very Low	1-10

Source: Adapted from *Assessing Internal Controls in Performance Audits*.

Column titled "Testing Limit" reflects Customs test sizes.

## Evaluation of Pre-Assessment Survey Testing Results

The following steps are guidance for determining the effectiveness of company's internal control over merchandise entered as products of insular possession.

- Complete the "Worksheet for Evaluating Internal Control Over Products of Insular Possessions" to determine whether risk determination is acceptable or unacceptable and to document why. Put results of testing in perspective and evaluate confirmed weakness as a whole. The evaluation should consider the results of the internal control testing, problems identified in the profile, and/or concerns raised by the import specialist and account manager. The team must evaluate the PAS results based on the specific situations.  
Customs considers risk to be unacceptable when testing reveals that internal control is not sufficient or effective in providing reasonable assurance that accurate, timely, and complete declarations are reported to Customs.
- The following will assist the PAS team in determining whether conditions warrant proceeding to ACT.
  - Do not proceed to ACT (Revenue) if:**
    - ✓ Cost benefit analysis warrants no further effort (do not spend a significant amount of resources to identify a potential loss of revenue considered insignificant).
    - ✓ The PAS indicated that the merchandise entered as products of IPs error was due to an isolated incident.
    - ✓ The company agrees with PAS finding(s) and agrees to quantify the IP loss of revenue within an acceptable timeframe.
  - Do not proceed to ACT (Compliance) if:**
    - ✓ An incorrect IP eligibility issue was isolated and the importer can show identical entry lines are correct.
    - ✓ The IP eligibility errors were systemic and the importer agreed to develop and implement a compliance improvement plan within an acceptable timeframe.
  - Proceed to ACT (Revenue) if:**
    - ✓ The company does not have adequate internal control, and the PAS indicated a material loss of revenue that cannot be quantified without statistical sampling or further review.
    - ✓ Importer will not quantify loss of revenue.

- **Proceed to ACT (Compliance) if:**

- ✓ The company refuses to take corrective action on systemic errors and it is necessary to calculate a compliance rate.

Note: If substantive tests necessary to determine a compliance rate or revenue loss can be quickly performed without extensive effort, the team should immediately perform the substantive tests without proceeding to ACT.

3. Determine whether referrals should be made for enforcement action.

### Examples

The following examples of situations that might be encountered under the PAS *are for clarification purposes only*:

*Example A: Situation in which the team would not proceed to ACT (Revenue)*

#### Background

The company's Customs compliance manual requires that its import manager obtain a declaration by the shipper for each crude oil shipment prior to importation into the U.S. Before a shipment can be released to the refinery, the company's import classification clerk from the shipping department must sign a shipment release certificate, which indicates whether or not, the shipment qualifies for products of IPs. The clerk determines whether or not the shipment qualifies based on 10.233(a)(3) of 19 CFR that applies specifically to petroleum.

If the goods qualify, a special trade indicator "Y" is stamped on the shipment release certificate. A copy of the shipment release certificate, and declaration by the shipper are submitted to the import manager for review, approval, and filing. The import manager forwards a copy of the approved documents to the broker for use in preparing the entry and filing. Once the Broker prepared the entry, a copy is sent to the import clerk to check for accuracy. The import clerk then sends a copy of the entry to the accounting department. The accounting department prepares a cash disbursement voucher and sends it to the import manager for payment.

#### The PAS Results

The PAS found that one of the six entries selected for review did not go through the company's review process to ensure it qualifies as a product of an IP. The entry involved crude oil that was not substantially transformed into a new product of the IP and therefore did not qualify. The company agreed with the PAS finding and quantified the loss of revenue. The company subsequently reviewed all entries, found all the untested entries that had not gone through the review process, and quantified the loss of revenue. Since Customs was able to determine that correction occurred proceeding to ACT was not necessary.

*Example B: Situation in which the team would not proceed to ACT (Compliance)*

Same situation as Example A above, except the PAS team was able to verify that controls were in place and working effectively. All six of the entries selected for review went through the company's review process to ensure the goods qualify for products of IPs. Therefore, proceeding to ACT was not considered necessary.



*Example C: Situation in which team would proceed to ACT (Revenue)*

Same situation as Example A above, except that the PAS found more entries of other commodities that did not go through the company's review process and the company was not able to quantify the loss of revenue. Therefore, proceeding to ACT was considered necessary.

*Example D: Situation in which team would proceed to ACT (Compliance)*

The same situation as Example A above, except that (as stated in its procedures manual) the company did not allow the import classification clerk from the shipping department to review the data and sign a shipment release certificate. The company refused to follow its written procedures or establish new procedures to correct the problems. Proceeding to ACT was considered necessary to determine the extent of the problem.

### Worksheet for Evaluating Internal Control Over Products of Insular Possessions

Objective: Determine whether the company has procedures designed to effectively control Customs risks related to merchandise entered as products of insular possessions (IP).

**Risk Determination:**

**Acceptable** \_\_\_\_\_  
**Unacceptable** \_\_\_\_\_

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
<b>Overall Controls</b>						
Are internal controls to ensure products of IP meet eligibility formally documented?						
Are written policies and procedures approved by management?						
Are written policies and procedures reviewed and updated periodically?						
Is one manager responsible for control of the Import Department, including products of IPs?						
Does that manager have knowledge of Customs matters and the authority to ensure that internal control procedures for imports are established and followed by all company departments?						
Does the responsible person have cost accounting knowledge?						

<b>Internal Control</b>	<b>Yes</b>	<b>No</b>	<b>Not Applicable</b>	<b>Internal Control Manual Page Number</b>	<b>Work Paper Reference</b>	<b>Comments</b>
Do written internal control procedures assign IP duties and tasks to a position rather than a person?						
Does company have good interdepartmental communication about IP matters?						
Does company conduct and document periodic reviews of products of IP?						
Does company use the IP periodic review results to make corrections to past and present entries?						
Does the company use the IP periodic reviews to make changes to it import operations as appropriate?						
Do internal controls involve a verification process to determine that the imported merchandise qualifies for IP?						
Is adequate descriptive information provided (by purchasing, engineering, supplier, and other department) to the Customs Department and/or broker to ensure proper IP classification and eligibility?						

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Does the importer have procedures to obtain any required or necessary documentation to support the claim (e.g., a contract penalty provision if IP information is not provided to Customs on demand)?						
Does the importer maintain an IP database or listing of imported merchandise that would readily identify IP transactions.						
Does the importer (or its agent) visit the plant in the IP country where the products are produced?						
Does the company perform an annual review of changes to IP?						
Does the individual overseeing compliance with products of insular possession requirements have adequate knowledge and training?						
<b>New IP Merchandise</b>						
Does management review the classification and eligibility of new IP items?						
Is responsibility for the IP eligibility process assigned to one knowledgeable individual or department with management oversight?						

<b>Internal Control</b>	<b>Yes</b>	<b>No</b>	<b>Not Applicable</b>	<b>Internal Control Manual Page Number</b>	<b>Work Paper Reference</b>	<b>Comments</b>
Is Customs assistance sought in classifying merchandise (e.g., requesting binding rulings).						
<b>Entry Review</b>						
Does the company review entries to verify that correct classifications were used?						
Does the company monitor the entry review process to verify that controls were followed?						
Are suppliers required to print company-provided HTSUS on invoices and/or packing lists?						
<b>Internal Control Conclusions</b>						
Does the company provide adequate broker oversight?						
Did PAS testing verify control procedures were being performed?						
Do interviews with responsible persons support control procedures?						
Does the company have internal control to address specific issues identified in the profile?						
<b>List company-specific procedures and controls below (if applicable)</b>						